

Intangible Assets - Initial Recording, Amortization, and Accounting Issues

Overview of Intangible Assets

Intangible assets are non-physical assets that lack a tangible form but provide economic benefits to an entity. Examples include patents, trademarks, copyrights, franchises, and goodwill. These assets are governed by **ASC 350** (US GAAP) and **IAS 38** (IFRS) for financial reporting purposes.

Characteristics of Intangible Assets

- Lack physical substance.
- Represent legal rights or competitive advantages.
- Generate future economic benefits, such as revenues or cost savings.

Initial Recording of Intangible Assets

Intangible assets are recorded on the balance sheet only when they are identifiable, controlled by the entity, and expected to provide future economic benefits.

Purchased Intangible Assets

- Recorded at their acquisition cost, including purchase price and any directly attributable costs (e.g., legal fees, registration fees).
- Example: A purchased patent is capitalized at its purchase price plus related costs.

Internally Generated Intangible Assets

- Costs incurred to create intangible assets internally (e.g., research and development) are generally expensed as incurred under US GAAP and IFRS, except in specific cases.
- Exceptions include:
 - **Development costs** under IFRS, which may be capitalized if specific criteria are met (e.g., technical feasibility, intent to complete, and ability to use or sell the asset).
 - Legal and registration fees for internally generated patents or trademarks, which are capitalized.

Amortization of Intangible Assets

Intangible assets with **finite useful lives** are amortized over their estimated useful lives, reflecting the period they are expected to generate economic benefits.

Amortization Process

- Amortization expense is recognized systematically, typically using the straight-line method, unless another method better reflects the asset's consumption pattern.

- Journal Entry:

- Dr Amortization Expense XXX

Cr Accumulated Amortization XXX

- Intangible assets with **indefinite useful lives** (e.g., certain trademarks or goodwill) are not amortized but are tested for impairment annually or when impairment indicators exist.

Accounting for Specific Intangible Assets

A. Patents

- A patent grants exclusive rights to use an invention, typically valid for 20 years from the filing date in the U.S.
- **Purchased Patents:** Capitalized at acquisition cost, including purchase price and related legal fees.
- **Internally Generated Patents:** Only legal and registration fees are capitalized; research and development costs are expensed.
- **Defending a Patent:** Costs of successfully defending a patent are capitalized as they enhance the asset's value. Unsuccessful defense costs are expensed.

B. Trademarks, Trade Names, and Copyrights

- Trademarks and trade names are distinctive signs, words, or symbols that identify a company's products or services.
- Copyrights protect original works of authorship (e.g., books, music) for the creator's lifetime plus 70 years in the U.S.
- **Accounting:** Capitalized at acquisition cost for purchased trademarks/copyrights. Internally generated costs are limited to registration and legal fees. Trademarks with indefinite lives (e.g., iconic brands) are not amortized but tested for impairment.

C. Franchises

- A franchise agreement grants the franchisee the right to operate a business using the franchisor's brand and systems.
- **Accounting:** The franchisee capitalizes the initial franchise fee and amortizes it over the franchise's useful life (typically the term of the franchise agreement). Ongoing royalty payments are expensed as incurred.

D. Leasehold Improvements

- Improvements made to leased property (e.g., renovations to a rented office) that revert to the lessor at the end of the lease.
- **Accounting:** Capitalized and amortized over the shorter of the lease term or the improvement's useful life.

E. Goodwill

- Goodwill arises in a business combination when the purchase price exceeds the fair value of the net identifiable assets acquired.
- **Amount of Goodwill:**
$$\text{Goodwill} = \text{Purchase Price} - \text{Fair Value of Net Identifiable Assets}$$
- **Accounting:** Goodwill is not amortized but tested for impairment annually or when impairment indicators exist. Costs to develop or maintain goodwill (e.g., advertising) are expensed as incurred.

Presentation of Intangible Assets

- On the balance sheet, intangible assets (excluding goodwill) are typically presented as a single line item, net of accumulated amortization.
- Goodwill is reported separately to enhance transparency.
- Disclosures include the nature of the assets, useful lives, amortization methods, and impairment losses.

Impairment of Intangible Assets

Impairment occurs when the carrying value of an intangible asset exceeds its recoverable amount, ensuring assets are not overstated.

A. Limited-Life Intangible Assets

- **Evaluation:** Assess for impairment whenever indicators exist (e.g., technological obsolescence, reduced demand).
- **Step 1:** Compare the asset's carrying value to the undiscounted sum of future cash flows from its use and disposal.
- **Step 2:** If impaired (carrying value > undiscounted cash flows), write down the asset to its fair value and recognize an impairment loss.

- **Journal Entry:**

- Dr Impairment Loss XXX

Cr Accumulated Impairment Losses XXX

B. Indefinite-Life Intangible Assets (Excluding Goodwill)

- Not amortized but tested for impairment annually or when indicators exist.
- **Step 1 (Qualitative, Optional):** Assess qualitative factors (e.g., market conditions, legal changes) to determine if it is more likely than not (>50% probability) that the asset is impaired.
- **Step 2 (Quantitative):** Compare the asset's fair value to its carrying value.
- **Step 3 (Write Down):** If fair value is less than carrying value, write down the asset to its fair value and recognize an impairment loss.

C. Impairment of Goodwill

- Goodwill is tested for impairment at the reporting unit level at least annually.
- **Step 1 (Qualitative, Optional):** Assess qualitative factors to determine if it is more likely than not that the reporting unit's fair value is less than its carrying amount.
- **Step 2 (Quantitative):** Compare the reporting unit's fair value (including goodwill) to its carrying amount (including goodwill).
- **Step 3 (Write Down):** If impaired, assign fair values to the reporting unit's assets and liabilities as if newly acquired. The implied fair value of goodwill is the excess of the reporting unit's fair value over the fair value of its net assets (excluding goodwill). Write down goodwill to its implied fair value and recognize an impairment loss.
- **Journal Entry:**

Dr Impairment Loss	XXX
Cr Goodwill	XXX

IFRS vs. US GAAP Differences

- **Development Costs:** IFRS allows capitalization of development costs meeting specific criteria, while US GAAP generally expenses them.
- **Revaluation Model:** IFRS permits revaluation of certain intangible assets to fair value, while US GAAP does not.
- **Goodwill Impairment:** IFRS uses a one-step impairment test (carrying amount vs. recoverable amount), while US GAAP uses a two-step process for limited-life intangibles and a qualitative/quantitative approach for goodwill.

Example Problem: Intangible Asset Amortization and Impairment

Scenario: On January 1, 2025, Company X purchases a patent for \$50,000 with a 10-year useful life and no salvage value. In 2027, due to technological changes, the patent's fair value is estimated at \$20,000, and the undiscounted future cash flows are \$25,000. Calculate the amortization expense for 2025 and 2026, and determine if the patent is impaired in 2027.

Solution:

1. Amortization Expense:

- o Annual Amortization = $\$50,000 \div 10 \text{ years} = \$5,000$ (straight-line method)
- o 2025 Amortization: \$5,000
- o 2026 Amortization: \$5,000
- o Carrying Value at End of 2026: $\$50,000 - (\$5,000 \times 2) = \$40,000$

2. Impairment Test in 2027:

- o **Step 1:** Compare carrying value (\$40,000) to undiscounted future cash flows (\$25,000). Since \$40,000 > \$25,000, the patent is impaired.
- o **Step 2:** Write down the patent to its fair value (\$20,000).
- o Impairment Loss = \$40,000 - \$20,000 = \$20,000

3. Journal Entry for 2027 Impairment:

4. Dr Impairment Loss	20,000
Cr Accumulated Impairment Losses	20,000

Payables and Accrued Liabilities

The original notes included a section on **Payables and Accrued Liabilities**, which appears unrelated to intangible assets but is relevant to general financial accounting. Below is a corrected and enhanced version of this section for clarity and completeness.

Categories of Liabilities

1. Reclassification of Short-Term Debt:

- o Debt due within the next 12 months is classified as a current (short-term) liability on the balance sheet.
- o **Demonstrating Ability to Refinance:** If a company intends to refinance short-term debt on a long-term basis and can demonstrate the ability to do so (e.g., through a financing agreement or post-balance-sheet refinancing), the debt may be reclassified as long-term. This requires:
 - A formal refinancing agreement signed before the balance sheet date.
 - Sufficient evidence of the ability to complete the refinancing (e.g., lender commitment).

2. Warranties:

- o Liabilities for warranties are accrued when a product is sold, based on estimated costs to fulfill warranty obligations.
- o Recognized as a provision under IFRS or an accrued liability under US GAAP.
- o Journal Entry:

Dr Warranty Expense	XXX
Cr Warranty Liability	XXX

3. Off-Balance Sheet Financing:

- o Refers to financing arrangements (e.g., operating leases, special purpose entities) that do not appear as liabilities on the balance sheet but may pose financial risks.
- o Under ASC 842 (US GAAP) and IFRS 16, most leases are now recognized on the balance sheet as right-of-use assets and lease liabilities, reducing off-balance-sheet financing.

Example Problem: Goodwill Impairment in a Business Combination

Scenario: On January 1, 2025, Company A acquires Company B for \$1,200,000, resulting in goodwill of \$300,000 (purchase price of \$1,200,000 less fair value of net identifiable assets of \$900,000). In December 2025, Company A performs an annual impairment test on the reporting unit containing the goodwill. The reporting unit's carrying amount (including goodwill) is \$1,500,000, and its fair value is estimated at \$1,400,000. The fair value of the reporting unit's net identifiable assets (excluding goodwill) is \$1,150,000.

Solution:

1. **Step 1: Qualitative Assessment** (skipped for simplicity, assuming quantitative test is needed).
2. **Step 2: Quantitative Assessment:**
 - o Compare the reporting unit's fair value (\$1,400,000) to its carrying amount (\$1,500,000).
 - o Since $\$1,400,000 < \$1,500,000$, the reporting unit is impaired, proceed to Step 3.
3. **Step 3: Write Down:**
 - o Calculate the implied fair value of goodwill:
 - $\text{Implied Goodwill} = \text{Reporting Unit Fair Value} - \text{Fair Value of Net Identifiable Assets}$
 - $\text{Implied Goodwill} = \$1,400,000 - \$1,150,000 = \$250,000$
 - o Carrying amount of goodwill = \$300,000
 - o $\text{Impairment Loss} = \$300,000 - \$250,000 = \$50,000$

4. Journal Entry:

5. Dr Impairment Loss	50,000
Cr Goodwill	50,000